Beneficiary designations with corporate-owned life insurance

For personally owned life insurance policies, the policyowner and beneficiary are often different people. However, for corporate-owned policies, the general guideline is to have both the corporate policyowner and beneficiary be the same entity.

Why do we have this guideline and when can we deviate from it? Would there be tax implications if a person or another corporation was the policy beneficiary? If this rule causes a road blocks in a client's estate planning, are there any solutions?

As noted, the general guideline for corporate-owned policies is to have a corporate policyowner be the beneficiary as well. This arrangement works well in most clients' situations, but sometimes it doesn't. Beneficiary designation options that diverge from this guideline may be categorized into two broad groups: individuals and corporations. We'll propose solutions for some of the common issues associated with each category.

Individual beneficiaries

In this category, either the individual shareholder's estate, or someone related to the shareholder, is the beneficiary of a corporate-owned policy. In these cases, the Canada Revenue Agency (CRA) considers the shareholder to have received a taxable shareholder benefit from the corporation equal to the amount of the insurance premiums paid. That amount would be included in the shareholder's income pursuant to subsection 15(1) of the *Income Tax Act* (Canada)[i]. Similarly, if the beneficiary is an employee of the corporation (not a shareholder), then the CRA considers an amount equal to the insurance premium paid by the corporation to be a taxable employment benefit of the employee.

However, for a shareholder there's no reason from a tax perspective to designate their estate as beneficiary because of the way life insurance proceeds credit a private corporation's capital dividend account (CDA). Life insurance proceeds received by a private corporation credit its CDA by the amount that the death benefit exceeds the policy's adjusted cost basis (ACB). A corporation can pay tax-free capital dividends to Canadian resident shareholders to the extent of its CDA balance. As a result, the shareholder's estate or family members (as estate beneficiaries or shareholders of the corporation) may receive all or a substantial portion of the insurance death benefit tax-free, depending on the policy ACB at death. In short, from a tax point of view, it generally doesn't make sense to have the individual shareholder or a family member be named as the beneficiary of a corporate-owned policy.

Corporate beneficiaries

In this category, a corporate policyowner designates another corporation as the policy beneficiary. In recent years, the CRA has made several statements regarding these arrangements.

It used to be common in family-owned businesses for a holding company to own the life insurance policy and the operating company be named as the beneficiary. In many cases, this arrangement made sense because:

- The policy's cash values, if any, were insulated from the operating company's creditors
- It provided corporate structuring options for making an operating company sale ready
- It provided additional estate planning options to clients.

The CRA expressed concerns about structuring the beneficiary designation in this manner because they feared it was being done to maximize the CDA credit available from the policy upon the life insured's death[ii].[2] Since the operating company (the policy beneficiary) didn't own the life insurance policy, it didn't have a policy ACB, and therefore would receive a CDA credit based on the *full* death benefit (with no reduction for the holding company's policy ACB).

The 2016 Federal budget addressed this unintended result. For deaths occurring after March 21, 2016, the CDA will be reduced by the ACB of the policy, even if the receiving corporation is not the owner of the policy. This amendment creates a reasonable outcome in most cases. However, the CRA has taken a strict interpretation to this amendment which has led to anomalous results. For example, if a policy has two corporate beneficiaries, the policy's full ACB reduces the CDA credit for each beneficiary. The ACB is not prorated by the portion of the total death benefit received by each beneficiary[iii]. Similarly, in a co-ownership arrangement, the policy's full ACB reduces the CDA calculation for a corporate owner, again the ACB amount isn't prorated by the portion of the total death benefit received by the corporate beneficiary[iv]. In these scenarios the ACB is effectively double-counted. Hopefully this will be addressed by another legislative amendment.

Prior to the legislative amendment the CRA also stated that structuring a policy's beneficiary designation to maximize the CDA credit without an identified business purpose could be challenged as an avoidance transaction under the *Income Tax Act's* general anti-avoidance rule (GAAR)[v].

Curiously, despite the 2016 legislative amendment and having GAAR at its disposal, the CRA still maintains a restrictive view on corporate beneficiary arrangements by alleging a taxable benefit arising in most cases where the policyowner and policy beneficiary aren't the same corporate entity. Let's look at this in the context of two scenarios involving a parent holding company (Parentco) and its 100% owned subsidiary (Subco).

Parentco is policyowner and Subco is beneficiary

In this scenario, Parentco is the policyowner and premium payor and Subco is the revocable beneficiary. The CRA considers Parentco to have conferred a benefit on Subco pursuant to subsection 246(1) of the *Income Tax Act* (Canada). It's not clear how the benefit would be quantified by the CRA. Presumably, it would be based on the insurance premiums paid to be consistent with its approach described above in respect to shareholder benefits. Based on subsection 246(1), the CRA would assess Subco by including in its income the amount of a benefit conferred on it by Parentco. This is to the extent that the amount would have otherwise been taxable had the amount of the benefit been a payment made to Subco directly. It can be argued this section does not apply in this scenario[vi], particularly on the basis that there are several variables that need to be satisfied before Parentco can reasonably be considered to have provided any benefit to Subco, namely:

- The person insured needs to die, and
- Before the life insured dies:
  - Parentco needs to maintain Subco as beneficiary
  - Subco needs to remain in existence

Also, if there's a benefit, what's its value of being a revocable beneficiary? IIs the answer as clear as stating it's the insurance premium when the cost of one year of insurance coverage may cost substantially less? This question is applicable in the context of both subsections 15(1) and 246(1). One could argue that if Subco was an irrevocable beneficiary there would be more value attributable to Subco. The CRA hasn't commented on that issue but it did say that in those circumstances that if Subco reimbursed Parentco for the insurance premium, then that amount might be income from property to Parentco under section 9 or paragraph 12(1)(x)[vii].

Subco is policyowner and Parentco is beneficiary

This is an uncommon situation where Subco is the policyowner and premium payor and Parentco is the revocable beneficiary. In this scenario, similar to the personal beneficiary context, the CRA considers Parentco to have received a shareholder benefit from Subco, which is taxable pursuant to subsection 15(1)[viii].

Solutions to the CRA's position on various beneficiary arrangements

There may be times when having a corporation as both policyowner and beneficiary doesn't accomplish a client's objectives. This may be seen in:

- Insured buy-sell arrangements
- Estate equalization where family members own shares of the operating company
- Where a policy's death benefit exceeds the value of the life insured's fixed-value preference shares

Fortunately, in the Parentco policyowner/Subco beneficiary context there's an exception from subsection 246(1) where the two parties are at arm's length[ix]. In a corporate context, this means that the two corporations aren't controlled by the same person or related persons. This exception is useful in insured buy-sell situations where the shareholders are at arm's length (generally means they aren't related). In these cases, the shareholders' respective individual holding companies may own the insurance policies on its owners' lives and the operating, or central holding company, may be the beneficiary.

In contrast, the exception doesn't help in insured buy-sell situations involving related persons (i.e. family members) who use holding companies to own their interests in the operating company. In these cases, the family members could do either of the following:

- Have the operating company buy term life insurance for the buyout funding and the permanent policy for long-term estate planning would be owned by the individual's holding company
- Set up a central holding company (to own the operating company) that would own the insurance and the buyout would occur at the central holding company's level

Conclusion

Having the same corporation as both policyowner and beneficiary can effectively accommodate the estate planning objectives of most clients. As a result, the CRA's generally restrictive position on the beneficiary designations for corporate-owned policies shouldn't factor into most discussions about corporate-owned life insurance. If it does, there might be simple solutions available or solutions that require some minor corporate restructuring.

[i] CRA document 2004-008190.
[ii] CRA Document 9824645.
[iii] CRA document 2017-0690311C6E.

[iv] CRA document 2018-0745811C6.
[v] CRA Document 2009-0347291C6.
[vi] See Lindsay, Patrick, "Taxable Benefits and Corporate-owned Life Insurance" CALU Report, Oct. 2015.
[vii] CRA Document 2010-0359421C6.
[viii] CRA Document 2009-0347291C6.
[ix] Subsection 246(2)

This material is for information purposes only and should not be construed as providing legal or tax advice. Reasonable efforts have been made to ensure its accuracy, but errors and omissions are possible. All comments related to taxation are general in nature and are based on current Canadian tax legislation and interpretations for Canadian residents, which is subject to change. For individual circumstances, consult with your legal or tax professional. This information is provided by The Canada Life Assurance Company and is current as of October 2021.